

Message Text

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TO AMEMBASSY LISBON IMMEDIATE

C O N F I D E N T I A L STATE 059862

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LIMDIS

E.O. 11652: XGDS-1

TAGS: EFIN, ECON, PO

SUBJECT: IMF NEGOTIATIONS WITH PORTUGAL

1. THE FOLLOWING MEMORANDUM TO THE FILES AND ATTACHED TABLES IS FOR THE POST'S BACKGROUND INFORMATION IN CONNECTION WITH CONSIDERATION OF A PROPOSED SCENARIO ON IMF-GOP TALKS BEING SENT SEPTTEL WITH A REQUEST FOR LISBON'S COMMENTS. NO, RPT, NO TELEGRAPHIC REFERENCE SHOULD BE MADE TO THIS MESSAGE, OR ANY OF ITS CONTENTS , UNLESS SLUGGED "STADIS FOR EUR/WE ONLY".

2. MEMORANDUM TO THE FILES DATED MARCH 8, 1978.

3. IN A TELEPHONE CONVERSATION ON MARCH 7, HANS SCHMITT ELABORATED ON THE STATUS OF IMF NEGOTIATIONS WITH PORTUGAL FOR A SECOND CREDIT TRANCHE PROGRAM. HE PROVIDED SOME CONFIDENTIAL

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BASIC DATA WHICH HE SAID WAS GIVEN TO THE FUND STAFF BY THE PORTUGUESE TECHNICAL GROUP, HEADED BY MRS. CONSTANCIO, DURING THEIR VISIT IN FEBRUARY. (SEE ATTACHED TABLE). SCHMITT THEN OUTLINED THE PROGRAM TARGETS WHICH HAD BEEN PROPOSED BY THE IMF DURING ITS CONSULTATIONS WITH PORTUGAL IN NOVEMBER.

4. SCHMITT SAID HE WAS VERY DISCOURAGED BY THE ATTITUDE THE PORTUGUESE HAD ADOPTED. HE SAID THE PORTUGUESE APPEARED UNWILLING TO IMPLEMENT THE IMF-RECOMMENDED MEASURES. HE THOUGHT CONSTANCIO WOULD AGREE TO A SLIGHT INCREASE IN INTEREST RATES AND A SLIGHTLY ACCELERATED DEVALUATION IN AN EFFORT TO APPEASE THE IMF, BUT THAT BASICALLY THE PORTUGUESE WERE COMMITTED TO FOLLOWING THE MIT PROGRAM DEVELOPED IN JULY, 1977. THIS PROGRAM CALLS FOR A REDIRECTION OF PUBLIC INVESTMENT, AWAY FROM IMPORT- USERS AND TOWARD IMPORT-SAVERS AND EXPORTERS. SCHMITT SAID THE PORTUGUESE INTENDED TO SET UP A FOREIGN EXCHANGE CREDIT RATIONING SYSTEM FOR THE PUBLIC SECTOR, A RESTRUC- TURING THROUGH THE FOREIGN EXCHANGE BUDGET.

5. SCHMITT CONTINUED THAT WHEN THE FUND TEAM WAS IN PORTUGAL IN NOVEMBER IT HAD MAINTAINED AN OPEN MIND REGARDING THE MIT PROPOSALS, AND HAD ASKED THE PORTUGUESE TO SHOW THEM IN DETAIL HOW THIS RESTRUCTING WOULD BE IMPLEMENTED. AFTER THREE WEEKS THE BEST THE PORTUGUESE COULD SHOW THE FUND TEAM WAS A POORLY-PREPARED, "BACK- OF-THE-ENVELOPE" ANALYSIS AND PROGRAM. DURING THE IMF TEAM'S RECENT VISIT TO PORTUGAL THE PAPERWORK FOR THE MIT-INSPIRED PROGRAM WAS STILL NOT COMPLETED.

6. SPEAKING FOR HIMSELF, SCHMITT SAID HE THOUGHT THERE WERE SEVERAL FACTORS CAUSING THE PRESENT NEGOTIATING CONFIDENTIAL

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DIFFICULTIES. FIRST, THE 1975 POLITICAL EXPERIENCE IS STILL VERY INFLUENTIAL IN DECISIONS BEING MADE TODAY. THE PORTUGUESE ARE STILL SCARED OF PRECIPITATING A RECURRENCE OF THAT SCENARIO. SECONDLY, CONSTANCIO HONESTLY DOES NOT BELIEVE THAT THE \$800 MILLION CURRENT ACCOUNT DEFICIT IS ACHIEVABLE -- EVEN ON AN APRIL/MARCH BASIS -- AND HE IS AFRAID OF THE REACTION OF LABOR UNIONS TO MEASURES REQUIRED TO APPROACH THAT TARGET. THIRDLY, SCHMITT THINKS THAT THE PORTUGUESE PERCEPTION OF THE IMF IS COLORED WITH A HIGH DEGREE OF MISTRUST. THE EXPERIENCE IN EGYPT HAS CONTRIBUTED TO THAT MISTRUST, AND THE MIT TEAM DOESN'T HESITATE TO POINT TO EGYPT AS AN EXAMPLE OF WHAT COULD HAPPEN IN PORTUGAL. SCHMITT THINKS THE TENDENCY IS FOR THE PORTUGUESE TO RUN FOR COVER WITH THE MIT TEAM, WHICH WAITS FOR THE IMF NUMBERS AND THEN UNDERBIDS THEM. SCHMITT'S ONLY RESPONSE WAS TO POINT TO THE RESULTS TO DATE OF FOLLOWING THE MIT PRO- POSALS -- AN OVER \$100 MILLION PER MONTH LOSS ON NET FOREIGN ASSETS.

7. ACCORDING TO SCHMITT, THE STRUCTURAL CURRENT ACCOUNT DEFICIT IN PORTUGAL IS ALREADY \$800 MILLION -- THE REST

REFLECTS SPECULATIVE ELEMENTS SUCH AS INVENTORY ACCUMULATION AND CAPITAL FLIGHT. THE ERRORS AND OMISSIONS ITEM ALONE IS \$700 MILLION IN 1977. THE BASIC PROBLEM WITH THE MIT PROGRAM IS THAT IT DOESN'T DEAL WITH THESE SPECULATIVE ELEMENTS. THE IMPLEMENTATION OF A SOUND PROGRAM IS THE ONLY WAY TO BRING THE MONEY BACK.

8. SPEAKING FOR HIMSELF AGAIN, SCHMITT SAID THAT BEFORE THE IMF RETURNS TO PORTUGAL TO INITIATE FORMAL NEGOTIATIONS HE WOULD LIKE TO SEE TWO THINGS: A DOUBLE-DIGIT DISCRETE DEVALUATION, AND AN INTEREST RATE INCREASE OF MORE THAN 5 POINTS. SCHMITT SAID HE HAD

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RECOMMENDED THAT ON THE DAY OF DEVALUATION CONSTANCIO IMPLEMENT AN INTEREST RATE HIGHER THAN NEEDED, IN ORDER TO ALLOW LEEWAY FOR LOWERING THE INTEREST RATE LATER AS A PUBLIC RELATIONS MEASURE. HE WAS NOT CONVINCED THAT THE PORTUGUESE WERE PREPARED TO DO ANY OF THESE THINGS. UNQUOTE

BASIC DATA

- PORTUGAL-IMF NEGOTIATIONS
- IMF
- 1976 1977 1978

PUBLIC SECTOR DEFICIT (ESC. BIL.) 54.9 51.1 40.2

BANK BORROWING BY PUBLIC SECTOR 31.6 49.6 35
(ESC. BIL.)

DCE (AS PERCENT OF M2) 24.1 32.9 20

REAL GNP GROWTH 5.8 7.0 4.0

UNEMPLOYMENT 6.7 7.0

AVERAGE WAGE INCREASE 19.0 18.0

CONSUMER PRICE INCREASE 19.3 27.0
YEAR ON YEAR

DOMESTIC CREDIT IN 1978: IMF: ESC. 110-120 BIL.
PORTUGUESE: ESC. 140 BIL.

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PORTUGUESE BALANCE OF PAYMENTS

-	1977-1978		
-	(MILLIONS OF U.S. DOLLARS)		
-	1977	1978	
-	ESTIMATE PROJECTION (1)		
-	(2)(3)		
CURRENT ACCOUNT	-1,385	-1,300	
DEBT AMORTIZATION	- 155	- 220	
FINANCING REQUIRED	-1,540	-1,520	
MEDIUM TERM CREDITS	760	900	
SHORT-TERM CAPITAL	4	4	
(INCLUDING ERRORS & OMISSIONS)-	735	- 750	
MONETARY MOVEMENTS	1,430	1,370	
-BANK OF PORTUGAL	900	550	
--FOREIGN EXCHANGE (MINUS INCREASE)	- 160	--	
--GOLD SALES	530	--	
--COMPENSATORY BORROWING	530	550	
-OTHER BANKS	530	--	
-RESIDUAL	--	820	

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-	DEC. 31,	DEC. 31,	
-	1976	1977	
NET FOREIGN ASSETS OF	325	-1,100	
BANK OF PORTUGAL			
GOLD RESERVES (VALUED AT	1,169	1,000	
OFFICIAL PRICE)			

(1)PROJECTION BASED ON PRESENT SET OF POLICIES.

(2)REPRESENTS 8 PERCENT OF ESTIMATED 1977 GDP.

(3)REPRESENTS 7 PERCENT OF ESTIMATED 1978 GDP.

(4)REPRESENTS LARGELY CAPITAL FLIGHT THROUGH LEADS AND
LAGS AND OTHER MEANS. VANCE

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